# DOW THEORY LETTERS INC.

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"He that passeth by, and meddleth with strife belonging not to him, is like one that taketh a dog by the ears." Proverbs 26:17

THE MARKET: What is the most bearish possible force on the market? The answer to this is a simple but fundamental truism; the steady liquidation of stocks by large, informed investment interests. I believe that this is what has been going on ever since the February bull market peak. In many high-grade issues it has been going on for over a year. Large investment sources are scared, they are selling shares day after day, month after month. Despite the fact that there has not yet been a panic or crash decline, they do not trust this market any more. They are trading their shares for cash, they are recognizing that cash is becoming the scarcest and most sought after commodity around. These large interests are not about to change their mind about stocks and cash any time in the near future. What we are seeing is a long-term trend, and it is easily discernible to anyone who will take the trouble to study the situation.

Take the March-April bear market rally. I showed subscribers how the low-priced stock index rose to a new high even while the Dow was undergoing a sharp 84 point correction. My reasoning (which in retrospect was correct) was that while the public and the speculators were rushing in to buy the high-flyers and glamour issues such as Electronics, Color TV's, Airlines, etc., the investment grade issues were under heavy pressure of liquidation. That constitutes a very bearish situation. I thought so at the time, and later events backed up my judgment. Despite the earlier almost hysterical enthusiasm for the "hot issues," the market tumbled during most of May, and a Dow Theory signal for a primary bear market was given on May 5.

A second but feebler rally took place during late May. The May rally was a weak follow-up of the ill-fated March-April rally, but it contained many of the same characteristics. Many high-flyers and glamour issues pushed up again, but this time few went to new highs. Volume dried up to under 5 million shares as the rally neared its May 27 peak, and it was obvious that enthusiasm was waning. A number of grade issues such as American Telephone, Int. Nickel, Int. Paper, DuPont, Texaco and Woolworth actually sank to new lows even while the rally was still in progress. This was poor action. It suggested that investment liquidation was continuing. Despite the obvious elation of the

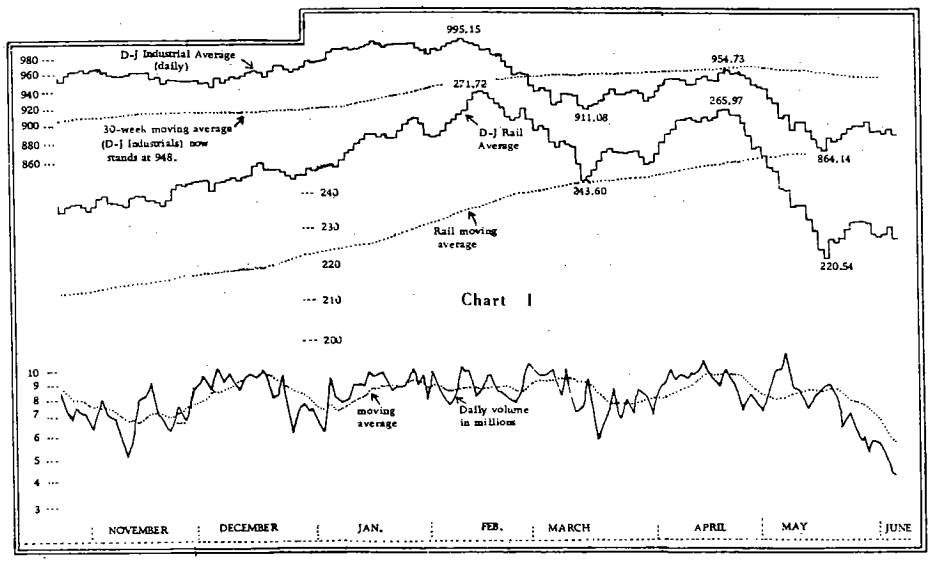
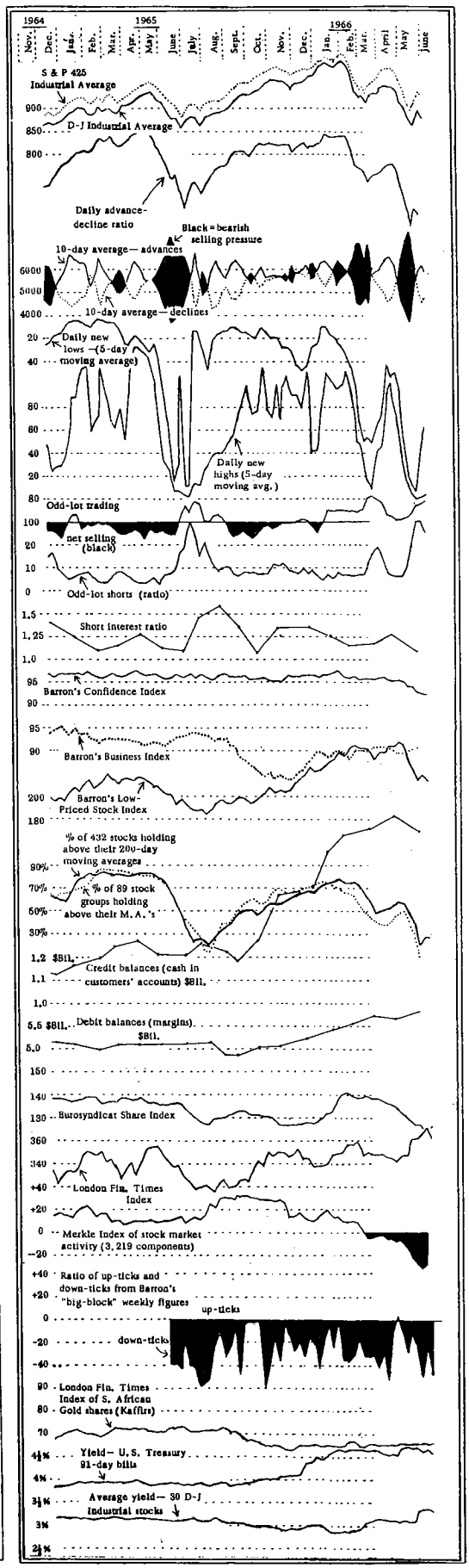


Chart I


1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

press and Wall Street, the rally could only be described as unconvincing.

In Letter 324 I wrote that during bear markets it is worth watching all four D-J Averages: Industrials, Rails, Utilities and the 40 Bonds. In fact, Letter 324 noted: "Last week the 40 Bonds dropped to the lowest level in four years. In time, I feel the other Averages will join the 40 Bonds." A bear market can be likened to an old rusty water-filled bucket. Stop up two holes, and the water continues to leak out of ten other holes. Stop up the ten holes, and three more holes appear. Always from somewhere the leakage continues. The bucket is "finished," and no amount of patching will do the job. It's the same with a primary bear market.

The 40 Bonds and the Utilities tend to be held by informed investment sources. They are not the type of vehicles which attract the public. Any time both of these Averages are breaking to new lows, the investment climate can be said to be poor. Why? Because a declining trend in the Bonds and Utilities indicates that big money is scared, that it is moving out of two of its favorite groups. On May 31 the D-J Utility Average broke to a new low for the year, the lowest level since 1963. The declining trend continued, and June 1 saw both the 40 Bonds and the Utility Average sinking to fresh new lows together. I consider this to be bearish action. It suggests to me (remembering that this is a primary bear market) that these two Averages could shortly be joined by the Industrials and Rails.

NOTES AND QUOTES: Confusion reigns in Washington. The Federal Reserve Board would like the Treasury to brake inflation by raising taxes (the Treasury, with elections coming, is reluctant to do this). The Treasury would prefer that the Fed take the blame for further "anti-inflation" measures by boosting the discount rate again. President Johnson simply hopes that the whole economic structure will hold together until election time. But LBJ is now fully committed to pursue the war in Vietnam (his last chance to pull out and save face came when the civil war broke out in Vietnam last month). In the test of whether LBJ will write off Wall Street or the war, Wall Street has been the loser.

* *

The Commerce Department has announced that the total U.S. debt is now $1.3 trillion. Of this, $904 billion is private, $362 billion is public. Half the total debt is corporate debt, and last year's rise of $43 billion in corporate debt was the greatest such rise in the history of the nation. The 1965 rise in corporate debt was $26 billion.

* *

While debt continues to expand, money rates around the world are pushing steadily higher (see news clips). Good European bonds are going at yields of 6% to 9%, the U.S. Treasury is getting into a steeper and steeper bind, and the odds for a whopping deficit next year loom large. In the face of all this, Treasury Secretary Fowler has gingerly asked Congress for a temporary "loophole" which would allow the current 4¼% ceiling on new Treasury bonds to be raised. The Treasury has stated that it would like Congressional permission to sell up to $5 billion of new bonds at whatever interest rate the market dictates.

Thus the money squeeze intensifies and many Treasury bonds are again banging into their lows of the last 40 years. Adding further pressure, the Federal National Mortgage Association will begin selling the first part of the Government guaranteed "Certificates of Participation" next week, thus sopping up whatever dollars are sill left "floating around." It all adds up to a potential money crisis in coming months, and this is probably the greatest peril with which the stock market has to contend. It is a crisis which shows no inclination to being solved. The war in Vietnam has taken care of that.

* * *

With an adverse balance-of-payments and a general maritime strike, Britain remains one of the Free World's great mysteries. Most mysterious of all is the strength of the British stock market. One guess regarding that strength is the possibility of an "acceptable" unilateral devaluation of the pound by perhaps 8% to 12%. As for the Rhodesian crisis, Prime Minister Wilson has adopted a complete change of policy. Wilson has jettisoned his original policy of trying to topple the Smith government in Rhodesia and is now seeking a negotiated settlement with Smith. Two reasons lie behind this hopeful turn of events. First, the pound would collapse completely if Britain turned to military force as a solution to Rhodesia. Second, South Africa could well back Rhodesia if a military confrontation loomed. A Rhodesian-South African war with Britain would be unthinkable. From Russell Kirk's syndicated column a week ago: "The armed forces of South Africa are as big as those of all Africa combined, and the S. Africans now manufacture their own military aircraft. Britain barely succeeded in defeating the Boers two generations ago. A second encounter, now that S. Africa is a power in her own right, would expose Britain to a defeat worse that that she suffered in the American Revolution."

* * *

April exports in the U.S. plunged 10% while imports rose 3%. Thus the favorable U.S. trade balance has dropped from a December high of $6 billion to a current annualized rate of $4.1 billion. Perhaps this prompted the editorial in the normally optimistic Business Week (May 28), a portion of which is included here.

"Although our foreign creditors appear temporarily willing to add to their store of dollars, this won't last indefinitely. Back in 1954, the Common Market countries held dollars as 53% of their total monetary reserves; by 1965, the proportion of dollars in their reserves was down to 24%. This decline in the ratio has been a direct result of deteriorating confidence in the dollar, which is related to the persistent balance-of-payments deficit. Building up dollar balances of unwilling foreign central bankers is a chancy business, to put it mildly."

West Germany Discount Rate Increased to 5%

Central Bank Rise From 4%, Second in Year, Is Aimed At Inflationary Pressures

Economy 'Difficulties' Noted

MONEY COST RISES IN SWITZERLAND

Bond Rates Seen Climbing in Step to Woo Investor

Special to The New York Times

GENEVA, May 23—Like most other things in Switzerland, money is becoming more pensive and many think that it

If the market continues to decline the first point of obvious interest will be the recent May lows of 864.14 and 220.54. If those lows are violated I would expect an approach and testing of the 1965 low of 840.59. Should the 840.59 level be broken, I would say, "Hold your hat!" I feel that a penetration of the 1965 low would be accompanied by great dismay and fear on the part of both Wall Street and the public, and that following such a penetration the worst and scariest part of the second leg of the bear market would materialize. This could well amount to a panic decline or a crash. A violation of the 1965 low could easily be followed by a deep probe by the Averages into much lower territory, perhaps as low as 650 to 750. This may sound incredible to today's readers, but I again remind you that this is a primary bear market. This is no reaction or "fooler" in a continuing bull market. In time, I believe that all my subscribers will come to realize what I am talking about.

I was interested to see that the majority of the investment fraternity and most of the investment services turned quite bullish again during the May rally. The fact is that they did not believe the May 5 Dow Theory bear signal, and they do not now believe that a true primary bear market is in progress. Market letters have become caught up in discussions of "over solds," "new buying opportunities," and "quick trading profits." The fact that Wall Street is in the grip of a powerful bear market simply does not register in the thinking of perhaps 99 out of every 100 people in the nation.

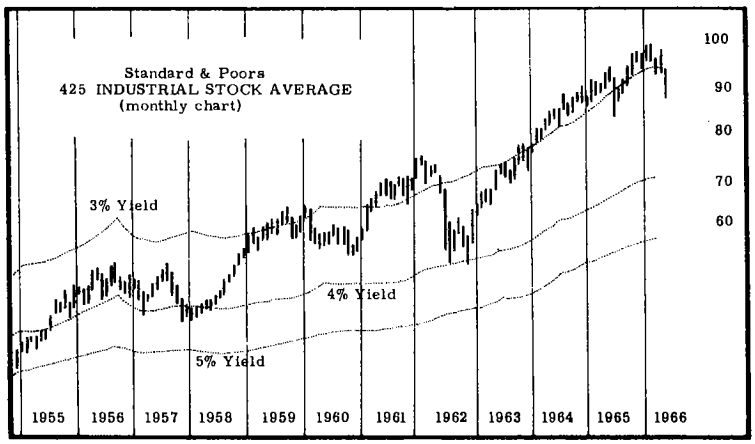
But what about the possibility that the market bottomed out with the Dow at the 864.14 May low, and that we are now backing and filling preparatory to an important correction, perhaps a correction of the whole 131 point drop? There is certainly this possibility, and I would be a fool to think that it could not occur. Here we might refer to the 50% Principle, a "gauge" which has worked particularly well in recent months (see Letter 322). In Letter 324 I stated that a 50% correction of the April-May drop could take Industrials back to approximately 909. On May 27 the Industrials closed at a rally peak of 897.04, a full twelve points under the halfway level of the April-May decline. Recessionary tendencies took over, and the Dow turned down

to test lower levels. The halfway level of the eight day May rally (864.14 to 897.04) is 880. My guess would be that if the Dow breaks below 880 (with increasing volume) then the lows of 864.14 will be in danger. On the other hand, if the Dow holds above 880, and then pushes first above 897.04 then above 909 a substantial and perhaps surprising retracement will be under way. Those are the gauges, but why guess? Let's let the market tell its own story from here on.

I do want to make one comment about volume which may be of help to subscribers. It is that dullness in bull markets and bear markets are two different "animals." Dullness, following a rally and recession in a bull market is ordinarily an indication of a "buy spot" and subsequent higher prices. The opposite is true during a bear market. Following a rally in a bear market, volume often turns dull and listless. Robert Rhea used to consider such areas ideal for shorting, for dullness in a primary bear market is all too often the prelude to the next major decline.

I am still receiving letters from subscribers asking whether they should continue to hold this or that stock. My only response is, "What have I been writing about?" If subscribers want to try to carry water around in a leaky bucket, what can I say? Any prospector out here in California will tell you that water is a precious article when you are heading out into the desert. Only a fool would head into the desert with a rusty bucket of water. But many otherwise intelligent men will head into a primary bear market with a fat portfolio of vulnerable stocks. In the end, the results are the same—panic and pain.

MONEY: There has been no change in the money picture, only an intensification of the world struggle for funds. A week ago West Germany raised its bank rate from 4% to 5%. In June Belgium boosted its bank rate from 4 3/4% to 5¼%. Canada is currently 5¼%, Japan is 5½%, Sweden is 5½%, London is 6% and the U.S. is still lagging behind at 4½%. The new spiral of rising bank rates overseas is putting further pressure on U.S. money markets, and already it is said that London "should" go to 7% to stem its reckless inflationary trend.

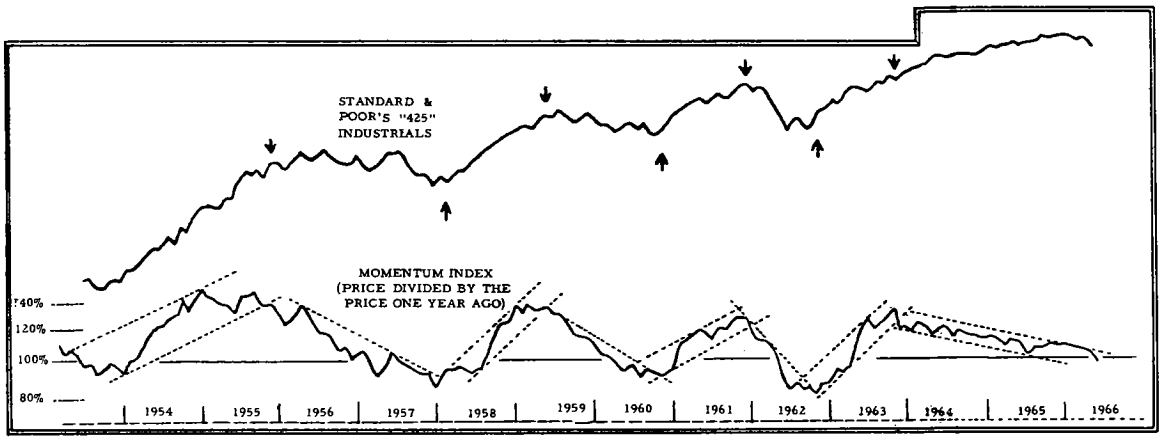



The spiral of money rates is not without its more practical effects. Last week the Federal National Mortage Association raised the rate it pays on short-term notes, the new rate being 5.15% on 59-day notes. According to the Wall Street Journal (May 1), April mortgage rates posted the steepest rise since the trend began in 1965. The rate is now the highest in three years with the interest rate on single-family home mortgages rising to an average of 5.99% in April from 5.90% in March. But the worst part of it is that regardless of rates, mortgage money is disappearing altogether. This means that hundreds of thousands of Americans are being frozen into their largest asset, their home. According to economist Eliot Janeway, "When the average family wakes up to discover that, suddenly, houses cannot be either bought or sold because the mortgage window is shut, a pullback in consumer spending and in consumer intentions to spend is inevitable. It is particularly unfortunate that this shock, and the resultant pullback, should have hit within weeks after the May 1 step-up in withholding schedules; we believe that the discovery of the sharper witholding bite after May 1 has had a very bearish effect, which has been largely unanticipated and which is still being widely underestimated."

From the standpoint of many subscribers, all of this means one thing: the value of our cash savings is steadily increasing. As the giant monetary squeeze continues, the purchasing power of our dollars increases in terms of the amount of equity which we will ultimately be able to purchase. I am including an excellent chart (courtesy of Value Trends, P. O. Box 12069, San Diego, Calif. 92112). This chart depicts dramatically what would occur if the broad S & P 425 Industrial Stock Average were to decline to a yield of 4% to 5%. If the 425 were to descend to an average yield of 5%, it would mean a tremendous drop in the 425 into the 50 area. But remember, bear markets by their nature tend to take stocks back to or below real values. It would be anything but surprising if this bear market took the 425 back to an average yield of 5% to 6% before this bear market exhausted itself. If so, the chart indicates that the losses to those investors who insist on riding their stocks will be tremendous.

MOMENTUM: If we toss a ball into the air, it will rise rapidly at first, but with each passing second its rate of ascent will slacken. Finally, there will be a point at which the rate of climb will cease—and the ball will hang motionless in mid-air. Following this, the ball will begin its descent back to earth. Thus the tossed ball gains upward momentum, losses it, hangs motionless, then assumes downward momentum. This same principle may be applied to the stock market.

Analysts make use of a variety of indicators with which to gauge the momentum of the market. Most of these devices are based upon changes (in percentages) of a given stock average over a specified period of time. For instance, an average may be continously compared with its own level a month ago, 200 days ago, six months ago or a year ago. One of the best of these so-called momentum indexes is the broad Standard & Poor 425 Industrial Average taken as a percentage of its own price one year ago.



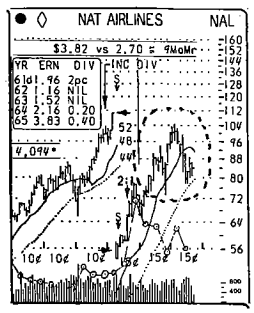

The accompanying chart traces 13 years of such action. The chart is constructed by dividing the end-of-the-month price of the Standard & Poor 425 Industrial Average by the price of that index exactly one year before. For reference purposes, the actual monthly closings of the S & P 425 have been traced on the chart.

As long as the momentum index (M.I.) is above 100, we know that the price of the 425 is higher than it was a year ago, and the converse is true when the M.I. is below 100. Note that the M.I. seems to travel along fairly well-defined rising or declining channels. Penetrations of these channels are often significant, providing early (sometimes very early) indications of impending trend reversals in the market.

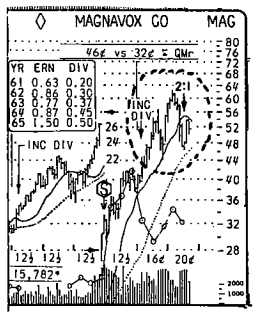
Ordinarily, it is constructive if the price of the S & P 425 is above its price of a year ago. It is particularly bullish if the ratio of the price is holding within a rising channel. For the latter means that the rate of improvement over the prior year is continuing.

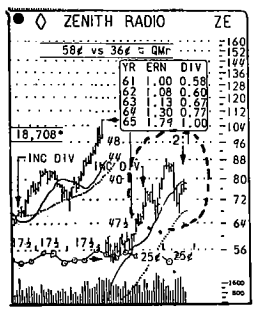
The picture portrayed by the M.I. over the past three years is extraordinary in that the movement is so extended. The last signal of change was given by the M.I. on November 29, 1963 (down-arrow on chart). At that time the M.I. broke below the rising channel which had formed during 1962 and 1963. For the past two-and-one-half years the M.I. has been gradually sinking, but as seen on the chart even the 1965 sell-off failed to take the M.I. below 100. But last week, at the May 31 closing of 92.15 for the S & P 425, the M.I. broke below 100 for the first time since 1962. The M.I. is now thoroughly bearish, having remained in a long descending channel and finally breaking below 100.

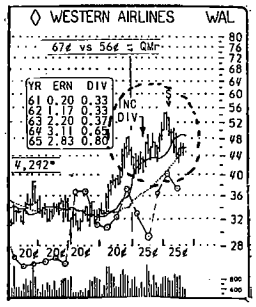
STOCKS: Many advisory services have recommended buying or holding stocks all through this bear market so far. With the Dow more than 100 points below its February peak, these advisors are now doing what I hate most to do in the investment business—they are sweating. They are trying to build bull market arguments, and they are (and this is natural) mixing hopes with facts. But if the market takes another plunge to new lows, these people will be subject to a new and perhaps even worse bout of real and paper losses. They will be thrown off balance from an investment standpoint, and will, in all probability, be pushed to the edge of panic and demoralization. Ask yourself whether it is worth riding out this type of pressure or whether you would rather be safely in Treasury bills and cash, watching the bear market develop. What's the risk in being out of the market at this time? Simply the risk of not "scalping" possible short-term profits on a further retracement which itself is open to doubt. So once again I implore my subscribers to get out of this bear market. If the 864.14 low of 1966 and then the 840.59 low of 1965 are violated, it will, in my opinion, be too late to do any calm and unemotional selling.

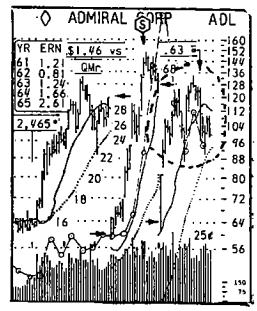



Some of the "high flyers" of recent vintage are forming (or have formed) right shoulders of large head-and-shoulders distribution formations. This suggests to me that such stocks as Admiral, Magnavox, Fairchild Camera, etc. could be subject to severe collapses if this market heads through the 1965 and 1966 lows. I include charts of five leading glamour stocks, and the dotted circles which I have drawn in, encompass the head-and-shoulders formations. Prognosis....danger for the market and perhaps crushing declines for many of the high-flyers.




LATE NOTES (Written June 7, after the opening): Volume has dropped to the lowest level since early 1965, and I sense that the recent speculative fever is now as cold as ice. The bear is again ready to fasten his teeth into the throat of the dieing bull. Often we can draw inferences by what does not happen in the market. It is striking that with 10 million shorts, the market cannot hold. If it were a bull market, 10 million shorts and low volume would turn the market completely resistent to decline. But this is a bear market. The shorts are with the trend. The speculators have rebuilt their little sand castles over the past few weeks. But I feel that the primary bear tide is again ready to sweep over them, washing them out to a merciless sea.

Charts at right courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas